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February 13, 2004

***Ex Parte* Electronically Filed**

Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: *Framework for Broadband Access to the Internet Over Wireline Facilities*, CC Docket No. 02-33; *Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112

Dear Ms. Dortch:

I am writing on behalf of AT&T Corp. in response to *ex parte* submissions by Verizon and BellSouth that each request exemptions from the Commission's cost allocation rules for various Bell-provided services.[1] Verizon asserts that, if the Commission decides that the Bells' "broadband" services were no longer deemed subject to Title II regulation, those services also could lawfully be exempted from the Commission's cost allocation rules. Verizon *Ex Parte* at 1. Similarly, BellSouth asserts that, once the Commission decides to allow the section 272 safeguards to sunset in a particular state, it should reverse its decision to treat "incidental interLATA services" (47 U.S.C. § 271(g)) as "nonregulated" so that the Bells no longer would be required to separate the costs of those services from the costs of regulated services. BellSouth *Ex Parte* at 1. Because the Bells maintain market power over regulated services and thus retain significant incentives to misallocate costs – which harms the Bells' rivals and ratepayers of regulated services alike – the Commission should deny both requests and apply its cost allocation rules to nonregulated services.

[1] *See Ex Parte* Letter of Richard T. Ellis, Verizon, to Marlene H. Dortch, FCC, WC Docket Nos. 02-33, 01-337, 95-20 and 98-10 (filed Jan. 6, 2004) ("Verizon *Ex Parte*"); *Ex Parte* Letter of Mary L. Henze, BellSouth, to Marlene Dortch, FCC, WC Docket No. 02-112, CC Docket No. 00-175 (filed Nov. 12, 2003) ("BellSouth *Ex Parte*").

A. Application Of Existing Cost Allocation Rules Would Continue To Be Necessary If The Commission Deregulated Broadband Services.

The Bells, including Verizon, have vigorously advocated that their "broadband" services should be subject only to regulation under Title I and not Title II of the Act. As AT&T has elsewhere explained, that would be unlawful. But if the Commission were to accept the Bells' Title I argument, it is undisputed that those services would be deemed "nonregulated" under the Commission's cost allocation rules and that the Bells would then be required to separate the costs of these newly deregulated services from the costs of their regulated services.[2] Along with BellSouth, Verizon claims that, with respect to any broadband services that would be deregulated, the Commission should not apply its cost allocation rules as they are currently written but instead should create a new and gaping exception that would allow the Bells to lump the costs of those services along with the costs of the remaining regulated, narrowband services.[3] Like BellSouth, Verizon claims that this separation of costs is unnecessary, burdensome, and "could" delay deployment of broadband services. Verizon *Ex Parte* at 1. But as AT&T explained in its responses when BellSouth presented these claims, none of these grounds for creating this exemption have any merit, and the Bells' proposals should be rejected.

1. Verizon Is Incorrect That Price Caps Eliminate All Incentives For The Bells To Misallocate Costs.

Verizon's most far-reaching – but least supportable – claim is that there is "no realistic threat" that the Bells would misallocate costs between broadband and regulated services. *See id.* at 1, 2-3. Of course, that assertion runs directly counter to the fundamental principle – which has been recognized "[s]ince the advent of . . . competition in the mid-1960s" – that "carriers with market power in regulated services" have significant incentives "to recover the costs of competitive services from subscribers to less competitive, regulated services by misallocating the costs of their competitive services."[4] The Commission's cost allocation rules

[2] *See, e.g.*, Letter of David Lawson, counsel for AT&T, to Marlene H. Dortch, FCC, at 2, WC Docket No. 02-33 (filed July 31, 2003) ("AT&T July 31 *Ex Parte*") (explaining application of cost allocation rules); *see also* Letter of Frank Simone, AT&T, to Marlene H. Dortch, FCC, WC Docket Nos. 02-33 and 01-337 (filed Oct. 2, 2003) ("AT&T Oct. 2 *Ex Parte*").

[3] *Compare* Verizon *Ex Parte* at 1 *with, e.g.*, Letter of Stephen L. Earnest, BellSouth, to Marlene H. Dortch, FCC, CC Docket No. 02-33, (filed Aug. 26, 2003).

[4] *Implementation of Section 254(k)*, 12 FCC Rcd. 6415, ¶¶ 2, 6 (1997) ("*Section 254(k) Order*"); *see also Regulatory Treatment of LEC Provision of Interexchange Services*, 12 FCC Rcd. 15756, ¶ 134 (1997) ("as long as the B[ells] retain control of local bottleneck facilities, they could potentially engage in improper cost allocation, discrimination, and other anticompetitive conduct"); *Implementation of the Non-Accounting Safeguards of Sections 271 and 272*, 11 FCC Rcd. 21905, ¶¶ 9-13 (1996) ("*Non-Accounting Safeguards Order*").

are one "important component" of a number of structural and accounting safeguards that are intended to prevent the Bells from acting on those incentives and thereby to protect ratepayers of regulated services from paying excessive rates.[5] Verizon does not seriously contend that it no longer retains market power over narrowband local services.[6] The Commission therefore must presume that Verizon and the other Bells – absent the cost allocation rules – would act on their incentive to load the costs of broadband services, if they are deregulated, onto regulated services.

Verizon's primary claim (echoed by BellSouth) is that the existence of price cap regulation means that the Bells would gain nothing by misallocating costs to nonregulated services, because inflating the costs of regulated services does not lead directly to rate increases, as it would under rate-of-return regulation. Verizon *Ex Parte* at 3. As AT&T and others have previously explained in response to the Bells' claims in various proceedings that price caps act as a panacea to any and all risks of anticompetitive conduct, there are numerous reasons why, despite use of price caps to regulate interstate services, the Bells would benefit by inflating the costs of their regulated services and understating the costs of services – like broadband – that face some measure of competition.[7] It is simply not true that price cap regulation eliminates all benefits that the Bells could achieve by misallocating costs. As the Supreme Court concluded in 2002, "price caps do not eliminate gamesmanship" primarily because price caps are "simply . . . a rate-based offset" that, like rate-of-return regulation, still provides "monopolies too great an advantage." *Verizon Communications Inc.* v. *FCC*, 535 U.S. 467, 487-88 (2002).

First, as Verizon and the other Bells must concede, many states regulate prices for intrastate services using either rate-of-return regulation or forms of price cap regulation containing sharing mechanisms that create direct links between prices and costs. As a result, the

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[5] *In the Matter of Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services*, 11 FCC Rcd. 18564, ¶ 39 (1996); *Accounting Safeguards Under The Telecommunications Act of 1996*, 11 FCC Rcd. 17539, ¶ 58 (1996) ("*Accounting Safeguards Order*"); *Southwestern Bell Corp.* v. *FCC*, 896 F.2d 1378, 1382 (D.C. Cir. 1990) (the Commission's joint cost rules are a reasonable "response to systematic incentives to shift costs").

[6] Verizon makes an offhand claim that it competes "head-to-head" with numerous carriers for local regulated services and that this competition constrains its "ability . . . to raise prices for regulated services." Verizon *Ex Parte* at 3. This claim has no basis in fact: Verizon and the other Bells still control virtually all of the market for regulated local services and are, quite properly, deemed to be "dominant" carriers, which by definition means they have market power and the ability to raise prices above cost.

[7] *See* AT&T Oct. 2 *Ex Parte* at 3-4; AT&T July 31 *Ex Parte* at 5-6 & n.10; AT&T Reply Comments, at 24-29, WC Docket No. 03-173 (Jan. 30, 2004) & Reply Decl. of Lee L. Selwyn ¶¶ 5-29 ("Selwyn TELRIC Reply Decl."); *see also* Letter of Gil M. Strobel, counsel to MCI, to Marlene H. Dortch, FCC, WC Docket No. 02-112, CC Docket No. 00-175 (filed Feb. 9, 2004).

Bells will gain by misallocating costs to less competitive services so as to gain relief from regulators.[8] The Commission has for this very reason previously rejected the Bells' arguments that price caps make it unnecessary to allocate costs between regulated and nonregulated services as prescribed by the Commission's rules.[9]

Second, even if such explicit sharing mechanisms are eliminated, price caps – both at the state and federal level – are based upon indices and various productivity targets. As Dr. Selwyn explained in the ongoing TELRIC proceeding, the Bells have incentives to misallocate costs so as to make their earnings appear reduced and obtain regulatory changes in the price cap system. Selwyn TELRIC Reply Decl. ¶¶ 11-12; *see* Kenneth Train, *Optimal Regulation* 327 (1991) (under price cap regulation, a firm will have an incentive to "waste so as to convince the regulator to allow a higher cap"). In fact, Dr. Selwyn reports that under most price cap plans, an incumbent's "failure to achieve a particular productivity target has in virtually every instance been rewarded by reducing the target itself." Selwyn TELRIC Reply Decl. ¶ 11; *see id.* ¶¶ 18-22 (discussing specific examples in which Bells urged regulators (often successfully) to reduce and/or eliminate productivity targets). These incentives exist both at the state and the federal level, particularly since the CALLS plan is due to expire soon and the Commission will be re-examining the Bells' access prices. Further, given the frequency with which incumbents' productivity targets have in fact been adjusted, it is by no means speculative to conclude that the Bells will misallocate costs to achieve regulatory relief.

These conclusions are further reinforced by recent findings of the Commission-convened Joint Conference on Accounting, which is comprised of members of this Commission and numerous state public utility commissioners. In its recent recommendations to the Commission to strengthen regulatory accounting rules (including creation of new accounts to track broadband expenses such as optical switches), the Joint Conference concluded that a dominant local carrier can benefit from cost misallocation by "making its regulated earnings

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[8] Verizon's suggestion that states using rate-of-return regulation can "base regulated voice rates on the standalone costs for narrowband services" (Verizon *Ex Parte* at 3) is ironic, to say the least. According to Verizon, it is "almost an impossible task" to extract the broadband costs from an "integrated modern network." *Id.* at 1. Whatever the merit of Verizon's claims (*see infra*), it is certainly much more difficult for a state to determine with accuracy the standalone costs of a narrowband network if, as the Bells propose, the incumbent – which has full information about its costs – is not required to apply longstanding cost allocation rules and to separate the costs of broadband services.

[9] *See Accounting Safeguards Order* ¶ 271 ("Moreover, because these incumbent local exchange carriers' intrastate services may be subject to cost-of-service regulation or to a form of price cap regulation that involves potential sharing obligations or periodic earnings reviews, the incumbent local exchange carriers may still have an incentive to assign a disproportionate share of costs to regulated accounts").

appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement."[10]

Third, the Bells retain significant incentives to misallocate costs – and particularly broadband costs if those services were deregulated – to inflate the prices their local service competitors pay for access to unbundled network elements. Even though the Act and Commission's rules require that UNE rates be based on forward-looking costs, as a practical matter, many of the cost models that are used to determine forward-looking costs rely as a starting point on the Bell-supplied data on current costs that are reported after the application of the Commission's cost allocation rules.[11] By manipulating that data and improperly including the costs of nonregulated services into regulated services, the Bells could raise their rivals' costs by unfairly inflating UNE prices. Given that the Commission recently determined that many broadband network elements are not subject to unbundling requirements, it is all the more vital that competitors obtaining access to narrowband UNEs pay rates that exclude the costs of broadband services. If the Commission were to deregulate broadband services but then not apply its cost allocation rules, then it will be far more difficult for state commissions to set UNE prices that properly reflect only the forward-looking cost of the narrowband element, and that do not include the costs (including an excessive share of joint and common costs) of any deregulated broadband services.

Fourth, as Dr. Selwyn recently explained, the Bells are able to game the price cap system because many so-called "competitive" services have been removed from price cap regulation, even though the Bells face little or no competition that in fact constrains their ability to raise prices. *See* Selwyn TELRIC Reply Decl. ¶¶ 13-16. In these circumstances, the Bells are able to raise prices for the services removed from price caps and then to shift the joint and

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[10] Recommendation by Joint Conference, *Federal-State Joint Conference On Accounting Issues*, WC Docket No. 02-269, at 24 (Oct. 9, 2003). Notably, Verizon and the other Bells have vigorously opposed the recommendations of the Joint Conference to improve the Commission's regulatory accounting rules, including the new accounts that track "the extent of deployment of new technology" used to provide advanced services. *Id.* at 18; *see, e.g.*, Comments of Verizon, WC Docket No. 02-269 (filed Jan. 30, 2004). In light of this opposition to updating the regulatory accounting rules, the Commission must reject out of hand Verizon's suggestion that it is inappropriate to apply cost allocation rules to broadband because they use accounting categories "that were developed long before broadband was invented." Verizon *Ex Parte* at 1.

[11] And of course, in the Commission's ongoing proceeding regarding its TELRIC rules, the Bells have vigorously contended that UNE rates should be determined through the use of their "actual costs." If that were permitted, then separating the costs of all nonregulated services, including broadband if the Commission were to deem it nonregulated, would be absolutely necessary to prevent competitors from paying UNE rates that, in effect, subsidize the costs of the Bells' broadband services.

common costs to the remaining price-capped services and away from non-price-capped services, generating excessive earnings for those services. *Id.* ¶ 15.

Further, as these examples illustrate, the Bells can significantly benefit by misallocating costs in a variety of circumstances where they raise their rivals' costs. Contrary to Verizon's claims, therefore, the Bells will gain from misallocating costs even if they do not also engage in a successful predatory pricing scheme that drives out their rivals. *See* Verizon *Ex Parte* at 2. Thus, the fact that it may be difficult for the Bells to eliminate their competitors in broadband and in nonregulated services in no way undercuts the benefits that the cost allocation rules provide to consumers of nonregulated services, including broadband services if the Commission were to deregulate them.[12]

For all of these reasons, it is Verizon that "ignores market realities" when it asserts that "there is *no* potential for regulated services to be burdened with non-regulated expenses." *Id.* at 2, 3 (emphasis added). Because the price cap system contains inherent imperfections, the Bells still retain significant incentives to inflate the costs of regulated services even if their prices are not generally determined by rate-of-return regulation. Accordingly, the cost allocation rules, which are aimed at reducing the Bells' abilities to act on their incentives to misallocate costs, continue to serve an important purpose by limiting cost misallocation and "ensur[ing] that ratepayers share in any efficiencies generated from joint use of the network by nonregulated activities." *Section 254(k) Order* ¶¶ 3, 6.

2. Verizon And The Other Bells Have Not Demonstrated That It Would Be Burdensome To Apply The Cost Allocation Rules.

Verizon also claims is that it is burdensome to separate the costs of broadband services from the costs of other services that would remain regulated. *See* Verizon *Ex Parte* at 1, 6. From that claim, Verizon – in typical "boy-who-cried-wolf" fashion – makes the dire prediction that disputes over accounting and cost allocation "possibly" could "delay" or even "h[o]ld hostage" broadband investment and deployment. *Id* at 1. Like the other Bells, which have made similarly baseless prophecies, Verizon never explains either why it would be unduly burdensome to separate broadband costs or, if that were true, how it would in fact seriously disrupt the Bells' deployment plans or would be so substantial as to outweigh the substantial benefits that ratepayers receive as a result of the cost allocation rules.

[12] Verizon's claim (at 2) that AT&T, MCI, and other providers of ATM and Frame Relay services are not injured when the Bells abuse their market power is simply incorrect. Although AT&T and MCI are among the leading providers of such services, they remain almost exclusively dependent upon the Bells for the underlying facilities used to provide those services, and would suffer significant harm if those facilities are not priced appropriately.

As an initial matter, it is not at all apparent why it would be particularly burdensome to apply cost allocation rules to any broadband services that are deregulated. Indeed, the "Commission designed the cost allocation system in such a way that it can accommodate the evolving nature of nonregulated activities," and, as a factual matter, the various "types of nonregulated services have continued to grow" since the cost allocation rules were established over fifteen years ago. *Accounting Safeguards Order* ¶ 58. Neither Verizon nor the other Bells have placed into the record any detailed facts or evidence explaining or quantifying the burden of applying the rules to broadband services if they were deregulated. On this record, therefore, there is no basis for the Commission to conclude that the straightforward application of its current and longstanding rules would create a tremendous burden.

Verizon points only to the fact that broadband services are provided over the same "integrated modern network" that is used to provide other regulated services. Verizon *Ex Parte* at 1. Of course, the cost allocation rules were developed precisely because carriers providing both regulated and nonregulated services incurred joint and common (*i.e.*, "integrated") costs, including not just overhead costs but network costs as well. Thus, the rules are by design intended to allocate "integrated" costs in a consistent manner. Indeed, the fact that broadband and other regulated local services may often share the same network only further confirms why it is so critical to apply the cost allocation rules to broadband services if they are deregulated. It is well-established that it is easier for the Bells to misallocate costs where regulated and nonregulated services share the traditional telephone platform. The Bells have contended that this integration provides significant benefits, and application of the cost allocation rules in these circumstances ensures that ratepayers of the regulated services obtain any cost savings and other benefits that might arise from the joint provision of these services. *Section 254(k) Order* ¶ 2.

Verizon's claim that application of the cost allocation rules would be too burdensome is particularly ironic given its positions in prior proceedings that, for other services the Bells provide (or, in the Bells' view, should provide) on an integrated basis, the cost allocation rules have successfully precluded cost misallocation and can be applied without burden even to shared expenses that are so intertwined that the Commission found they presented "substantial opportunities for improper cost allocation." *Non-Accounting Safeguards Order* ¶ 163. For example, in urging the Commission to remove its longstanding and broad prophylactic ban against the joint provision of operating, installation and maintenance ("OI&M") services between a Bell and its separate Section 272 affiliate, Verizon told the Commission that the "accounting safeguards for allocating shared service costs between regulated and nonregulated services" have been "used successfully" for other regulated and nonregulated services provided on an integrated basis.[13] The same logic would apply to allocating costs of broadband and remaining regulated services. Further, although the Commission has not previously applied its cost allocation rules to the sharing of OI&M services between local and long distance facilities (since the Bells have always been categorically banned from sharing OI&M), Verizon nowhere asserted in those proceedings that it would be difficult or burdensome for the Commission to "monitor these [new] cost allocations effectively through its accounting rules."[14] That is so even though the Commission has found – just as Verizon claims is true for the shared costs of broadband and other local services – that proper allocation of expenses if OI&M services were to be shared requires "regulatory involvement in the operation, plans, and day-to-day activities of the carrier . . . to audit and monitor the accounting plans" used by the carrier. *See Non-Accounting Safeguards Order* ¶ 163. The Commission could not rationally agree with Verizon and decide that it can easily apply its accounting rules to prevent misallocation of OI&M costs, and then turn around and determine that it is too burdensome to apply those rules to prevent broadband expenses from being misallocated to regulated services.

3. Verizon Does Not Explain How The Commission Could Meet Its "Continuing Obligation" Under Section 254(k) To Ensure Proper Allocation Of Joint And Common Costs.

Verizon's final argument (at 3-5) attempts to respond to the showings of AT&T and MCI that the Commission would violate section 254(k) if it agreed with the Bells and deregulated broadband services but then exempted them from the cost allocation rules. Section 254(k) contains a broad prohibition forbidding any telecommunications carrier from cross-subsidizing competitive services with services that are not competitive. 47 U.S.C. § 254(k). And it also directs the Commission to establish "any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide

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[13] *See, e.g.*, Reply Comments of Verizon, at 11, 16-17, CC Docket No. 96-149 (filed Sept. 24, 2002) ("Verizon 96-149 Reply Comments"); *see id*. Comments of the Verizon Tel. and Long Distance Cos., at 12-13, WC Docket No. 03-228 (filed Dec. 10, 2003) (in other markets where Bells compete in nonregulated markets, such as inside wiring maintenance, customer premises equipment, and information services, "nonstructural safeguards have proved sufficient to check discrimination and cost misallocation").

[14] Verizon 96-149 Reply Comments at 16; *id*. at 11; Verizon Petition for Forbearance, at 4, CC Docket No. 96-149 (filed Aug. 5, 2002) (stating there is "no fundamental difference" between the cost allocations necessary to monitor shared OI&M services than other integrated services); *see also Ex Parte* Letter from Dee May, Verizon, to Marlene H. Dortch, FCC, CC Docket No. 96-149, 01-337 and WC Docket No. 02-33, at 3 (filed June 4, 2003) (explaining application of Part 64 cost allocation rules to OI&M services); *Ex Parte* Letter from Dee May, Verizon, to Marlene H. Dortch, FCC, CC Docket No. 96-149, at 4-5 (filed June 24, 2003) (same).

those services." *Id.* In implementing this section, the Commission found that § 254(k) "places a *continuing obligation* on the Commission to ensure that the treatment of joint and common costs" prescribed by the Commission's rules safeguards the availability of universal service. *Section 254(k) Order* ¶ 8 (emphasis added). In particular, the Commission found that section 254(k) "supplements our existing [cost allocation] rules" and "addresses the concern that ILECs may attempt to gain an unfair advantage in competitive markets by allocating to their less competitive services, for which subscribers have no available alternative, an excessive portion of the costs incurred by their competitive operations." *Id.* ¶ 7. The Commission therefore implemented § 254(k) by codifying that section's prohibition on cross-subsidization in its rules and finding that its existing cost allocation rules act as the safeguard required by section 254(k). *Id.* ¶¶ 3, 6, 8. Thus, even if it made sense to do so, the Commission could not exempt broadband services from its existing cost allocation rules, unless and until it first implemented new cost allocation rules to meet its 254(k) mandate.

Verizon's response (at 3-4) largely attacks a straw man: it attempts to defend the view that the Bells could not be found to be in immediate violation of the "first sentence of section 254(k)" – *i.e.*, the broad prohibition against cross-subsidies – if the Commission agreed with the Bells and deregulated broadband and then exempted those services from the cost allocation rules. But neither MCI nor AT&T is contending that the Commission should in this rulemaking proceeding determine whether the Bells would in fact be engaging in cross-subsidies that are prohibited by the first sentence of § 254(k) if the Commission deregulated broadband services and then exempted them from the cost allocation rules. Rather, MCI and AT&T have both argued that the Commission would violate the *second* sentence of section 254(k) – *i.e.*, the continuing obligation that the Commission establish rules allocating joint and common costs – if it deregulated broadband and simultaneously eliminated the rules that ensure the Bells do not misallocate costs from broadband to services that continue to be classified as regulated.[15]

Verizon's *ex parte* fails to grapple in any serious manner with this argument. Verizon's only claim is that the second sentence of § 254(k) is meant merely to ensure that the "costs of providing universal service are not borne disproportionately by the universal service fund." Verizon *Ex Parte* at 5. But that cramped reading is plainly not consistent with the text, which directs that the Commission "shall establish" any and all "cost allocation rules" to prevent a misallocation of joint and common costs to any universally-supported service. The Commission has already concluded that § 254(k) squarely addresses the broader "concern" that the Bells will allocate an excessive portion of the costs of nonregulated operations to less

[15] *See, e.g.*, MCI Sept. 15 *Ex Parte* at 3 ("as long as costs are tied to rates, Section 254(k) requires that the Commission have in place effective cost allocation rules before making a determination regarding the reclassification of DSL services"). Although AT&T is confident that the Bells are in fact engaging in illegal cross-subsidization, it is certainly not a requirement to prove such a claim in order to show that there is a violation of the *second* sentence of § 254(k).

competitive services (*Section 254(k) Order* ¶ 7) – precisely the danger that would be presented if the Commission deregulated broadband and allowed the Bells full discretion to allocate joint and common costs of providing broadband and regulated local services.[16]

If broadband were deregulated, Verizon identifies no "cost allocation rules, accounting safeguards, [or] guidelines" (§ 254(k)) that would replace the protections currently provided by the Commission's cost allocation rules. For the reasons described above, the existence of price cap regulation would not provide adequate safeguards to "ensure" (*id.*) that the Bells do not engage in cost misallocation. Indeed, because price caps were instituted well before Congress enacted section 254(k), Congress plainly did not believe that price caps could by themselves prevent the cost misallocation that would occur when the Bells provide both regulated and nonregulated services. The Commission would violate its "continuing obligation" under § 254(k) to prescribe appropriate accounting rules if it exempted broadband services from the cost allocation rules after it deregulated those services. *Section 254(k) Order* ¶ 8.

In short, Verizon is correct (at 6) that this proceeding presents the Commission with "momentous decisions" about the proper regulation of broadband services. Congress permitted the Commission to encourage deployment of advanced services, but Congress was also explicit that the Commission must not permit consumers of the Bells' regulated narrowband services to bear the costs of deploying advanced services. To effectuate Congress's clear intent and to prevent the Bells from acting on their powerful incentives to misallocate costs, the Commission should not create an arbitrary exception to its cost allocation rules for any deregulated broadband services.

B. Application Of The Cost Allocation Rules To Incidental InterLATA Services Is Necessary Because The Bells Retain Market Power After The Commission Determines That Section 272 Safeguards Should Sunset.

BellSouth seeks a similar exemption from the Commission's cost allocation rules for "incidental interLATA services," *see* 47 U.S.C. § 271(g), which are deemed to be nonregulated for the purposes of those rules such that the Bells must separate the costs of those services from the costs of other regulated services. BellSouth *Ex Parte* at 1. According to BellSouth, whenever the Commission determines that the section 272 separation, nondiscrimination, and accounting safeguards no longer should apply to a Bell's interLATA operations, it should reverse its current treatment of incidental interLATA services as

[16] Verizon's claim (at 5 & n.13) that the Commission would not violate § 254(k) because USF contributions are not linked to the cost allocation rules is false. In addition to rules on USF, the Commission also must have rules in place – like the cost allocation rules – that ensure that no universally-supported service (such as basic local exchange and exchange access) bears a disproportionate share of joint and common costs. That prohibition can (and would in this case) plainly be violated even if the USF distributions were correctly and fairly instituted.

nonregulated, thereby allowing the Bells to commingle costs of these services with the costs of regulated services like local exchange and exchange access that are not subject to effective competition. BellSouth's claim rests on virtually the same grounds as Verizon's request – *i.e.*, that cost allocation is burdensome and unnecessary in light of price caps (*see id.*) – and should be rejected for the reasons discussed above.

The primary distinction between Verizon's and BellSouth's claim is that BellSouth proposes that its exemption from the cost allocation rules apply only after the section 272 safeguards are permitted to sunset. Under section 272(f)(1) of the Act, those safeguards sunset in a state 3 years after the date a Bell is authorized to offer long distance service in that state, unless the Commission extends the safeguards, which Congress expressly authorized it to do. As AT&T has previously made clear, under any proper reading of the Act and of Congress's clear purposes in enacting section 272, the Commission should extend the application of the section 272 safeguards until the Bells' market power over local services has dissipated and there is no risk that the Bells will be able to engage the anticompetitive discrimination and cost misallocation that section 272 was enacted to prevent.

In those circumstances, the Commission's elimination of section 272 safeguards would signify that the Bells no longer possess market power. Accordingly, absent market failures, there would be no need to apply the cost allocation rules to Bell services, including incidental interLATA services, because the actual erosion of their market power through robust and irreversible competition would eliminate their incentive and ability to misallocate costs. Unfortunately, the Commission has improperly interpreted section 272 and has decided to allow the section 272 safeguards to sunset in several states well before the Bells' market power has even begun to dissipate – although it has refused repeatedly even to explain the basis for its decisions.

Because the sunset of section 272 safeguards in no way indicates that the Bells' market power has in fact dissipated, there is no basis to revise the treatment of incidental interLATA services for purposes of the cost accounting rules – either now or when the § 272 requirements sunset for a particular state. In 1996, the Commission determined that application of its cost allocation rules to incidental interLATA services was necessary to "prevent any improper cost allocations that may occur between local exchange and exchange access services and these interLATA telecommunication[s] services." *Accounting Safeguards Order* ¶ 74. In this regard, the Commission noted that, in addition to the prohibition on cross-subsidization contained in section 254(k) and discussed above, Congress also specifically provided in section 271(h) that the "Commission *shall ensure* that the provision of" incidental interLATA services authorized under section 271(g) "*will not* adversely affect telephone exchange service ratepayers or competition in any telecommunications market." 47 U.S.C. § 271(h) (emphasis added). The Commission found that it could "most efficiently and comprehensively satisfy sections 254(k) and 271(h)" if it treated incidental interLATA services as nonregulated for purposes of its accounting rules so that the Bells would be required to apply the cost allocation rules to those services and separate the costs of those services from the costs regulated services. *Accounting Safeguards Order* ¶¶ 73-75.

As with Verizon's claim, BellSouth nowhere explains why it would be appropriate or, for that matter, lawful for the Commission to reverse this conclusion. In fact, the Commission has re-affirmed its determination that incidental interLATA services should be deemed nonregulated in several subsequent decisions – including decisions that maintained that classification even when the Commission determined that it could forbear from applying aspects of § 272 to particular Bell-provided incidental interLATA services.[17] In these forbearance decisions, the Commission in effect permitted certain of the § 272 safeguards to "sunset" for the particular services at issue – but it always insisted that the Bells shall treat these incidental interLATA services as nonregulated and "shall segregate the costs of providing [the services] in accordance with our Part 64 cost allocation rules" so that integrated provision of such services will not adversely affect telephone exchange service ratepayers or competition, as Congress directed in § 271(h). *U S West NDA Order* ¶ 37 n.95. The Commission could not grant BellSouth's current request without creating an irreconcilable conflict with these prior decisions.

Like Verizon, BellSouth claims that it would be burdensome to separate the costs of incidental interLATA services. But this claim has even less merit than Verizon's, for it is undisputed that the Bells have been applying the cost allocation rules to incidental interLATA services since 1996, with no unusual burdens. Further, the Commission already rejected this very same argument, finding that "because [ILECs] currently have internal accounting systems in place to allocate costs fairly between nonregulated activities and regulated services provided on an integrated basis," application of the cost allocation rules in this case "will not impose extensive expense." *Id.* ¶ 75.[18]

As noted, BellSouth also claims that the existence of price caps makes it "not necessary" to apply the cost allocation rules to incidental interLATA services. BellSouth *Ex Parte* at 1; *id.* at 4. But for all the reasons described above, price caps do not remove the Bells' incentives to misallocate costs, and thus application of the cost allocation rules represents the minimum amount of regulation necessary to "sufficiently safeguard against cross-subsidization."

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[17] *See, e.g.*, *In the Matter of Petition of U S West Communications, Inc.*, 14 FCC Rcd. 21086, ¶ 37 & n.95 (1999) ("*U S West NDA Order*"); *In the Matters of Bell Operating Companies*, 13 FCC Rcd. 2627, ¶ 85 (1998); *In the Matter of BellSouth Petition for Forbearance*, 15 FCC Rcd. 6053, ¶ 20 n.58 (Apr. 11, 2000).

[18] BellSouth's explanation (BellSouth *Ex Parte* at 3) of why it would be burdensome to separate the costs of incidental interLATA services is – like Verizon's analogous claims – also undercut by its statements that the Commission could easily apply its cost allocation rules and other safeguards to prevent misallocation of OI&M costs. *See, e.g.*, Comments of BellSouth, WC Docket No. 03-228, at 8 (filed Dec. 10, 2003).

Accounting Safeguards Order ¶ 75. In fact, the Commission recognized that it was the existence of "the complement" of a variety of regulatory safeguards, including the cost allocation rules *and* price caps, that permitted the Commission to implement Congress's directives in section 254(k) and 271(h) without crafting new safeguards to apply to incidental interLATA services. *See Non-Accounting Safeguards Order* ¶¶ 97-98. In light of these findings, the Commission could not lawfully reverse its decision to apply the cost allocation rules to incidental interLATA services.

Sincerely,

/s/ Michael J. Hunseder

Michael J. Hunseder